Long Term Global Growth

Reflections

March 2023

Catch-22 Earnings

'We are focusing on profitability.' Perhaps unsurprisingly, this has been the repeated mantra of most earnings calls over the last six months. And it is being reflected in actions too; each week, a different company adds to the 'headcount rationalisation' tally.

Management knows this is what many shareholders and market watchers want to hear. After all, much weight is ascribed to this elusive number, 'earnings'. It is an input to many reductionist spot metrics: price/earnings ratio, earnings per share, margins, return on investment calculations, and even gearing. And in times of elevated inflation and tightening monetary policy earnings are viewed, somewhat, as a safe haven and need to be protected at all costs.

A third of the Long Term Global Growth portfolio does not generate any earnings. A cause for concern? We believe not.

Earnings are an invention of US accounting standards established after the Wall Street Crash of 1929. Transparency and standardisation were deemed necessary by regulators to mitigate a recurrence. But companies and economies do not look the same as they did in the 1920s and 30s. They have undergone monumental transformations and the accounting standards have been left behind.

Increasingly, 'bulk-material manufacturing' is being replaced by an economic regime that is 'knowledge-based.' As Professor Brian Arthur of the Santa Fe Institute points out, this has seen the processing of resources and the application of raw energy be replaced by the processing of information and the application of ideas.

This shift is in part responsible for the explosive growth of the last two decades. Network and flywheel effects of platforms such as AWS, Moderna, and Cloudflare have proven the success of the knowledge-yielding part of the economy.

'Capital light' may spring to mind when thinking of these businesses. However, this grossly misconstrues the level of investment these companies undertake to fuel their growth and deepen their competitive moats.

While it is true that they do not require heavy machinery or more traditional notions of property, plant and equipment, huge amounts of capital is poured into intangible investments that will subsequently create long-lasting future value, such as customer acquisition costs, employee training, and software development.

These investments are underserved by current accounting standards. Unlike the purchase of a factory, which is recognised on the balance sheet as an asset and depreciated to the income statement over time, intangible investments hit profits, in full, in the year incurred; often hidden across several lines of the income statement: research and development, sales and marketing, and even general and administrative costs. The result is lumpier and depressed earnings, as well as flawed calculations for returns on invested capital. For those knowledge-yielding companies in the heavier investment phase of their lifecycle, this accounting quirk is magnified.

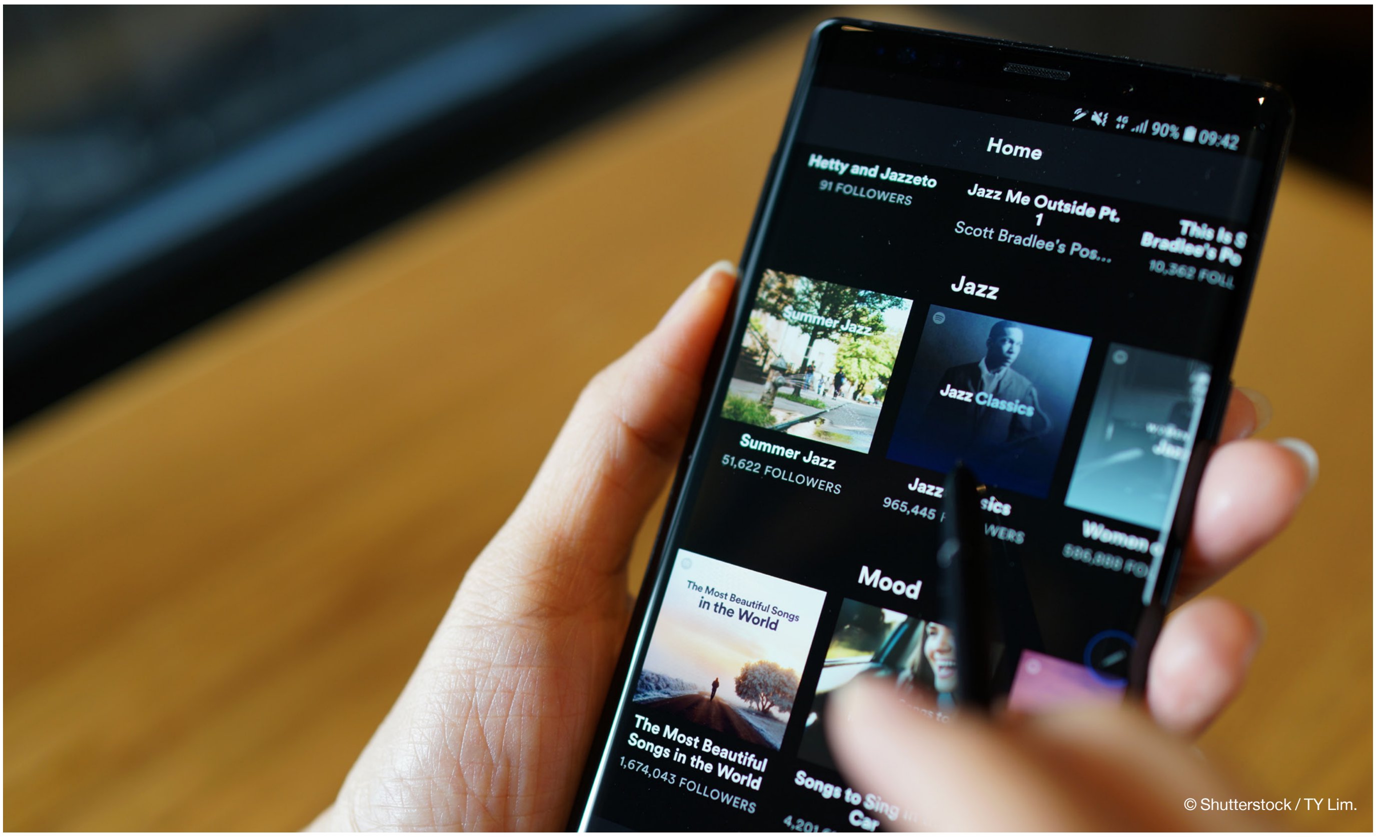
Spotify, for example, offers a ‘freemium’ model to attract a large number of users and aims to convert these into paying subscribers. Absorbing this cost has unequivocally aided Spotify in establishing its brand identity and building its competitive moat, and importantly generates a healthy flow of recurring revenues from a sticky customer base once converted. This sounds like an investment but there is no asset on the balance sheet and a direct hit to earnings.

This is a topic that has been examined at length by several academics of accounting. And research suggests that the level of intangible investment currently slipping through the income statement depresses the net income of the S&P 500 by as much as 12 per cent.

Is it likely that this effect is even more pronounced in the LTGG portfolio? Yes.

We can take research and development as a percentage of sales as a proxy. This is where it is hardest to distinguish between costs that are necessary to maintain the steady state and those that are in fact value accretive. The portfolio’s R&D as a percentage of sales today is 15 per cent, three times that of the index.

While this complexity may be unsettling, it creates an opportunity for bottom-up, fundamental equity investors. There is greater scope for these exceptional capital allocators to be disregarded by the market in the short term because their ‘earnings’ look depressed. Recent history tells us that it is those knowledge yielders that are providing superlative returns. Our investment process and analytical framework appreciates that not all value can be derived from company financials and identifying exceptional growth requires nuance.



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Important information and risk factors

Annual Past Performance to 31 March Each Year (Net %)

	2019	2020	2021	2022	2023
LTGG Composite	8.4	10.7	104.4	-18.1	-18.1
MSCI ACWI	3.2	-10.8	55.3	7.7	-7.0

Annualised returns to 31 March 2023 (Net %)

	1 Year	5 Years	10 Years	Since Inception*
LTGG Composite	-18.1	10.5	15.2	11.4
MSCI ACWI	-7.0	7.5	8.6	7.6

*Inception date 29 February 2004.

Source: Baillie Gifford & Co and MSCI. US Dollars.

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